ICPS

European Focus

#10, 2010

Budget support from the EU: Unrealized potential

Victoria Gumeniuk

Poorly implemented foreign aid is actually bad for Ukraine. When carrying out numerous foreign aid projects and programs replaces the work of real reforms, the effect is a mere imitation of active reform work and the results just pie in the sky.

So far, foreign assistance has not helped Ukraine set up a system of transformation knowledge management because it failed to shape a critical mass of knowledge and skills, it neglected to set up institutions to manage foreign assistance and ensure a breakthrough and systemic reforms, and it thus failed to catalyze systemic reform in Ukraine.

Ineffective foreign aid is actually bad for Ukraine

The European Union began to propose sectoral budget support to Ukraine back in 2007 and the first agreement was signed in September 2008. According to the European Commission's formulation from 2007, "...an important change in the modality of aid occurred in Ukraine, that is, a shift in the direction of Sectoral Budget Support (SBS) to strengthen political dialog and increase the role of the government in this process. SBS programs are determined on the basis of a Sector Readiness Assessment that, in turn, is based on seven criteria, three of which are qualification criteria: a strategy in the sector, a suitable macroeconomic environment, and an independent system for managing public finances. If one or more criteria are not fulfilled, the conditions for preparing an SBS are considered not satisfied."[1]

The EU has a well-established practice of providing budget support to partner countries, especially in Africa. The decision to use this budget support instrument with Ukraine is a kind of political signal indicating that the EU wishes to trust our country and support its reform processes. In an absolute sense, the amount of budget support allocated to Ukraine is modest. At the same time, the format of budget support adds an element of conditionality to this assistance, requiring the fulfillment of criteria even before money is handed out for budget support.

Budget Support – putting concepts to work

Budget Support (BS) is the primary type of financial assistance provided through the European Neighborhood and Partnership Instrument (ENPI). It is defined thus:

> "...the transferring of funds by the agency that is providing external financing to the partner country's Treasury is on condition that the latter upholds the agreed terms of payment. Funding received in this manner is part of the overall resources of the partner country, which should be used in accordance with the public finance management system of the partner country."[2]

Budget support can be either general or sector-specific:

- ◊ General Budget Support (GBS) involves transferring money for the execution of national development or strategic reform plans.
- ◊ Sectoral budget support (SBS) involved transferring money for the execution of programs aimed at the development of specific economic sectors.

Budget Support consists of a series of payments or tranches. The European Commission transfers the first or "fixed" tranche on condition that national executive bodies have met specific requirements in the preliminary assessment, while the receipt of subsequent or "flexible" tranches depends on meeting certain benchmarks set within the support program.

---

[1] Outline of EC Concept on "Potential priority zones for national ENPI indicative programs in Ukraine," 2011—2013, p. 14.

[2] OECD/DAC, *Harmonizing donor practice to provide more effective assistance*, Vol. 2, 2006 p.

Budget Support, which makes up 70% of the national component of the ENPI in Ukraine for the period 2007 through 2009, arises from the need to support national development priorities in the partner country. And indeed, the European Consensus on Development specifies that: "The European Commission now has a more clearly defined coordinating and channeling role on behalf of the EU and its member states. Assistance may be given using any number of instruments, that is from technical assistance to general and sectoral budget support. The EU expects the overall amount of budget support to third countries to expand up to 50% in 2010."[3]

How Budget Support started in Ukraine

The story actually begins in 2005, when Ukraine and the European Union signed a Memorandum of Understanding (MoU) on cooperation in the energy sector on 1 December. In March 2006, the Government of Ukraine adopted the Energy Strategy of Ukraine through 2030.

After the preliminary assessment, an Agreement on Funding the EU External Assistance Program called "Support to Institute Ukraine's Energy Strategy" was signed on 17 March 2008. The preliminary assessment involved these seven criteria, the first three being the key ones:

- strategy/sectoral development program;
- macroeconomic situation;
- system for managing public finances;
- budget and medium-term expenditure framework;
- coordination of donor assistance;
- performance assessment;
- institutional assessment and capacity-building.

The European Commission did not publish the results of its preliminary assessment prior to deciding to allocate funding for budget support purposes. But discussions with experts in launching Budget Support programs made it clear that Ukraine failed to meet two of the three main criteria!

The quality of the energy sector strategy underwent a severe critique by experts. Among others, Serhiy Yermilov, director of the Institute for Environmental Issues and Energy Conservation, noted violations of the principle of comprehensiveness in the development of Ukraine's Energy Strategy.[4]

The macroeconomic situation deteriorated in 2008 because of the global financial crisis and panic on financial markets, a deteriorating hryvnia exchange rate, defaults in the banking system, and hold-ups in wages and salaries.

The EC released funding for the energy sector despite Ukraine's clear lack of capacity to use this money effectively

Ukraine's system of managing public finances, according to a SIGMA assessment,[5] was not in line with international standards and remains so to this day. The process of harmonizing Ukraine's system with international norms is currently underway with the support of several international technical assistance programs.[6]

Yet Ukraine's failure to meet the criteria did not stop the EC from transferring the first tranche of EUR 23mn in December 2008, as the first part of its SBS allocation of EUR 82mn to support he country's energy strategy. However, no further money has been disbursed.

3 The European Consensus (2006/C 46/01), a joint statement by the Council and representatives of member-country governments on the Council, of the European Parliament and the EC regarding the political future of the European Union.

4 http://www.dt.ua/2000/2200/53482/

5 Support for Improvement in Governance and Management (SIGMA). Source: http://www.oecd.org/dataoecd/43/58/38292432.pdf

6 1) Assistance to the Main Oversight Administration of Ukraine in instituting a new system of internal financial control (Twinning Program), 18.09.2007 – 17.12.2009; donor: EU Commission.

2) Project to modernize public finance, 2008 – 2013, as part of a loan from the IBRD (World Bank).

Sore points in the implementation process

In addition to the fact that the basic criteria hadn't been met, a number of other problem areas were also uncovered:

Procedure for disbursing funds: This is done following the rules and procedures of the recipient country, which are currently missing in Ukraine. The Ministry of Finance has just begun to work these up in partnership with the Ministry of Economy. So far, the money from the first BS program has not been used.

Awareness among officials: Because governmental civil servants are ignorant of the opportunities offered by the BS program, they are unable to carry it out effectively.

Monitoring and evaluation: Although responsibility for managing funds lies with the recipient country's government, there is no working mechanism on the Ukrainian side for monitoring and evaluating the progress of the BS program.

Formally, control over the execution of the program is the responsibility of a specially-formed Joint Monitoring Group (JMG). Although this group is required to meet every two months, so far it has met only twice: 8 September 2009 and 15 February 2010. Importantly, the JMG includes both Ukrainian officials and representatives of the EC, but there is no provision for representatives of the NGO sector to be involved at all.

Gap between EU requirements and the powers of individual ministers: Not all benchmarks for successful execution of the BS program fall within the competence of the Ministry of Fuel and Energy, such as the requirement to present and enact the Law "On state procurements" in line with EU norms.

The first BS program for Ukraine is a test for the European Commission as an effective donor and for the Government of Ukraine as a reliable partner in terms of commitments taken on. Should the program fail to be carried out properly, future BS programs that are currently in the planning stage are likely to be postponed.

The cost of failure of the first BS program: EUR 209mn

EU Sectoral Budget Support for Ukraine 2008–2009

At this time, the EU and Ukraine are preparing to launch two BS programs:

◊ Developing trade and commerce (norms and standards). EU support: EUR 45mn (Budget Support EUR 39mn, Technical Assistance EUR 6mn)

◊ Increasing energy efficiency. EU support: Budget Support EUR 70mn (Budget Support EUR 63mn, Technical Assistance EUR 7mn)

The European Commission also gave preliminary approval for joint financing of two more sectoral programs in 2009*:

◊ Developing the transport sector. Planned EU support: EUR 40mn (Budget Support EUR 35mn, Technical Assistance EUR 5mn)

◊ Environmental protection. Planned EU support: EUR 77mn (Budget Support EUR 72mn, Technical Assistance EUR 5mn)

* *Funds are disbursed in the year following the planning year.*

The value of the BS instrument depends entirely on the readiness of the Government in the partner country to effectively manage this resource. Ukraine's unreformed government machine *ipso facto* is incapable of carrying out strategies that are being drawn up in order to get funding rather than as a guideline to the actual execution.

Yet responsibility for the ineffectiveness of aid cannot be placed entirely at the feet of the Ukrainian side. Aid is a two-way street.

At the point where the recipient country is assessed according to EC criteria, an effective trap is set. Any compromise on the results of the assessment indicates just one thing: support for the unreformed state of Ukraine today and the interest of European countries to any way issue funds in direct violation to their own requirements.

What next?

First of all, an honest and thorough assessment of the scale of unreformed government institutions in Ukraine by representatives of the European Commission is needed. The EC has not been willing to acknowledge how unready Ukraine is for assistance such as Budget Support. Yet to propose a policy-driven assistance to a country whose state institutions are opaque and unreformed is the same as building a castle on sand. As long as the ineffective and corrupt system of public administration in Ukraine remains in place, no systemic reforms will be possible.

Secondly, the nature of assistance should not be based on condescension and compromise but on strictness and conditionality, The EU knows how to reform countries as it succeeded in bringing the government institutions of countries that joined the European family in the last six years up to standard.

Right now, Ukraine and the EU need to direct aid at democratizing the system of government in Ukraine

Only after a major reconstruction of the foundation and roof will it be possible to consider cosmetic improvements in Ukraine. This means the most important step right now is to direct foreign aid resources towards democratizing the public administration system in Ukraine and bringing it in line with EU standards.

Victoria Gumeniuk is a senior analyst, Head of Foreign Aid Program at ICPS.

European Focus is an ICPS monthly that raises debate on key issues of European integration for Ukraine, EU policy towards Ukraine, and other important issues connected to Ukraine's European ambitions. This publication is financed by the Think-Tank Fund of the Open Society Institute.

e-mail: office@icps.kiev.ua
www.icps.com.ua